No. 9901.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

FONTANA POWER COMPANY, a corporation,
Petitioner and Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee.

APPELLANT'S OPENING BRIEF.

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Record on Appeal.

This proceeding is to review a decision of the United States Board of Tax Appeals, hereinafter called "Board". The record on appeal consists of an agreed statement of the case under rule 76 of the Rules of Civil Procedure. The agreed statement is printed in full in the transcript, which latter is hereinafter referred to by the letter "T", and its pages by their numbers. Thus, "T 7" refers to page 7 of said transcript. Incorporated in the transcript are the findings of fact and opinion of the Board [T 21]. The facts found or stated in said findings were incorporated in and adopted as a part of such agreed statement with the proviso that any statement in said findings in conflict with any other fact or statement incorporated in the agreed statement should give way to and be controlled by such other fact or statement.

Jurisdiction.

Appellant filed income tax returns for the calendar years of 1935, 1936 and 1937 with Collector of Internal Revenue at Los Angeles, California. The office of said Collector is within the Ninth Circuit [T 23]. Thereafter, the Commissioner of Internal Revenue determined deficiencies in appellant's income tax and excess profits taxes for said years [T 1]. Appellant petitioned the United States Board of Tax Appeals to redetermine such deficiencies. Thereafter, said Board entered its decision redetermining deficiencies in the same manner as did the Commissioner [T 21]. Thereafter, appellant filed with said Board a petition for review of said decision by this court [T 2]. A copy of said petition is incorporated in the agreed statement of case under said rule 76 [T 22]. Jurisdiction to review said decision is conferred upon this Court by paragraph (a) of section 1141 of the Internal Revenue Code, reading "The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board", and by paragraph (b)(1) of said section 1141, stating "such decisions may be reviewed by the Circuit Court of Appeals for the circuit in which is located the collector's office to which was made the return of tax in respect of which the liability arises."

Statement of the Case.

The sole question involved on this appeal is whether certain payments made by appellant to Fontana Union Water Company (hereinafter called "Water Company"), under an agreement of date January 30, 1917 [T 31] were deductible from appellant's gross income.

In its findings of fact and opinion [T 7-21], the Board referred to these payments as being appellant's net income

or net profits. The agreement required payment of appellant's net profits over amounts required for dividends and all of appellant's obligations. Except for the erroneous statement in this particular, the Board's findings of fact constitute a fair statement of the case. Such findings are here repeated in full and the same constitute all of this statement, with the exception of the last paragraph hereof.

Findings of Fact.

The parties have fully stipulated the facts in this proceeding, and, as stipulated, we have adopted those facts, which are materially as follows:

The Fontana Power Co., petitioner herein, was incorporated under the laws of the State of California on or about April 3, 1916, and at all times since has functioned as a public utility corporation, subject to the jurisdiction of and regulation by the Railroad Commission of the State of California. Its principal place of business is at Fontana, California.

The Fontana Union Water Co., hereinafter called the Water Co., was incorporated in 1912 under the laws of the State of California as a mutual water company for the irrigation of farm lands in the vicinity of the town of Fontana. The Water Co. has been held by the Bureau of Internal Revenue to be exempt under section 101 of the Revenue Acts of 1934 and 1936 from income and capital stock taxation.

The Fontana Co. was incorporated under California law prior to petitioner, and continued to be so incorporated until it was dissolved in 1927.

A. B. Miller was president of all three corporations.

Prior to August 9, 1916, the petitioner made application to the Railroad Commission of California for a certificate that public convenience and necessity require the construction of an electrical power plant and system near the town of Rialto; and for leave, *inter alia*, to execute a mortgage on its properties and to issue thereunder $350,000 face value of first mortgage 6 percent bonds, and for leave to acquire from the Water Co. and the Fontana Co. certain properties and property rights. Thereafter, prior to October 10, 1916, petitioner filed with the commission a supplemental application reciting that it appeared impossible at that time to prepare and submit to the commission data sufficient to enable the commission to fix the value and approve the purchase price of the properties proposed to be conveyed by the Water Co. and the Fontana Co. to petitioner. The application stated that petitioner had an option to purchase certain steel required for use in construction of its proposed pressure pipes, which option would expire October 6, 1916, after which time the price of steel would be considerably higher due to the wartime market. In order to prevent the loss of this steel contract and allow further time in which to prepare data for the commission respecting the fixing of the value and approval of the purchase price of the properties, it was proposed to enter into an agreement providing for the immediate conveyance of the properties to petitioner for the consideration of: (1) 100 shares of capital stock in the petitioner corporation; (2) petitioner's covenant to pay the Water Co. and the Fontana Co. the difference between the value of the 100 shares and the value of the properties so to be conveyed as soon as the value and the method of payment could be agreed upon between the three corporations and approved by the

commission; and (3) the further covenant of petitioner that, pending the fixing of the value and making of payment, the petitioner, from time to time, would pay over to the Water Co. and the Fontana Co. all its earnings remaining after paying or providing for payment of its operating expenses, taxes, and interest and all obligations it might have incurred or for which it might have become responsible.

Thereafter, on October 10, 1916, the Railroad Commission of California made and rendered its decision granting petitioner authority to issue the 100 shares of capital stock of the par value of $100 per share as part payment to the Water Co. and the Fontana Co. for a powerhouse site and certain property rights and to issue the $350,000 of its first mortgage 6 percent bonds upon certain conditions, and granting authority to petitioner to enter into the proposed contract with the Water Co. and the Fontana Co. on the proposed terms, conditioned upon the approval by the commission of a copy of the contract to be thereafter filed by petitioner. The commission also declared that public convenience and necessity required the construction by petitioner of the proposed hydroelectric power plant and system.

Thereafter, on January 30, 1917, the Railroad Commission of California issued a supplemental order approving the mortgage and trust deed, which approval was the condition precedent to the issuance of the mortgage bonds. The supplemental order recited that the $350,000 6 percent mortgage bonds were to be secured by a mortgage upon all the property then owned or thereafter to be acquired by petitioner.

On February 6, 1917, the Railroad Commission of California issued a second supplemental order, reapproving

the mortgage and trust deed in slightly amended forms. Thereafter, on June 6, 1917, the commission, by its third supplemental order, authorized petitioner to enter into a contract with the Water Co. and the Fontana Co. substantially in the form of the contract as filed with the commission on February 23, 1917, which contract has heretofore been set out in substance.

Thereafter, on June 15, 1917, petitioner entered into the contract with the Water Co. and the Fontana Co. and the latter two corporations conveyed the properties and rights to the petitioner. Pursuant to the commission's order petitioner also executed the trust indenture, and bonds of petitioner in the amount of $350,000 were issued and sold under the indenture, and the proceeds were used in the development of petitioner's property. The properties and rights acquired from the Water Co. and the Fontana Co. were leased by petitioner to the Southern California Edison Co. for 30 years, commencing July 1, 1917, and were mortgaged by petitioner under the trust indenture to secure its bond issue.

When petitioner was incorporated, 5 qualifying shares were issued. Thereafter, pursuant to the commission's order authorizing the contractual agreement with the Water Co. and the Fontana Co., petitioner issued to the Fontana Co. 50 shares of stock and a like number to the Water Co. In 1927 the Water Co. acquired the 50 shares originally issued to the Fontana Co., and also acquired all interests and rights originally acquired and owned by the Fontana Co. under the agreement; and at all times since the Water Co. has been, and still is, the owner of the 100 shares of stock and of all rights originally acquired by the Fontana Co. and the Water Co. in and under the agreement. These 105 shares of stock are the only

shares of petitioner corporation which have ever been issued.

During the year 1937 the Water Co. and the petitioner executed an agreeement for the purpose of construing and resolving the meaning of certain provisions of the original agreement. By this 1937 agreement petitioner was allowed to deduct from its gross income, when calculating net income for the purposes of the original agreement, all charges for discount of its outstanding bonds and any expense in connection therewith. By order of October 25, 1937, the Railroad Commission of California approved this interpretation of the agreement.

During the year 1917, petitioner constructed the proposed hydroelectric plant on the powerhouse site, and also constructed pipe lines along the right of way conveyed to it by the Water Co. and the Fontana Co. Aside from income arising out of its business, petitioner never acquired any property of substantial value other than that conveyed to it by the deeds from the Water Co. and the Fontana Co., and the improvements acquired with the proceeds from the sale of the bonds.

Commencing July 1, 1917, and at all times since its construction, the plant has been operated by the Edison Co. under the lease whereby petitioner reserved and receives electricity generated in said plant for supplying its customers, and the Edison Co. pays a rental determined by and based upon the excess power generated in the hydroelectric plant. At all times since the plant's erection the only business of petitioner has consisted of supplying its customers in the Fontana territory with electric power, either generated at its plant, or, in the case of a deficiency for its requirements, purchased and received by petitioner from the Edison Co.

The amounts claimed by petitioners as deductions from gross income, which amounts were disallowed by respondent (being $18,262.39, $16,244.55, and $27,000 for the years 1935, 1936, and 1937, respectively), were paid by petitioner to Water Co. pursuant to that provision of the agreement between the corporations calling for the payment of all annual net income.

The value of the properties and rights conveyed to petitioner by the Water Co. and the Fontana Co. has not yet been fixed, and the method of payment of the remainder of the purchase price thereof has not yet been determined, and, since the commencement of petitioner's operations in 1917, all of its net income in excess of operating and other expenses and an 8 percent dividend on its outstanding capital stock has been paid to the Water Co. and the Fontana Co., pursuant to the agreement between the three corporations.

No orders have been issued by the Railroad Commission of California bearing on the valuation of the properties conveyed to petitioner or bearing on the agreement between the three corporations or the lease to the Southern California Edison Co. or the trust indenture or the bonds issued thereunder other than the orders mentioned above.

No attempt has at any time been made by petitioner to fix the value of the properties conveyed to it or to secure the approval of the Railroad Commission of California to the fixing of that value other than the mention of the value of $349,500 in the amended application of petitioner to the commission in October, 1916. Petitioner has never made any of the payments provided for in the agreement other than to issue the 100 shares of stock and the payments of income, as per agreement, as set out above.

In its annual reports to the Railroad Commission of California and in its Federal tax returns from 1917 to date, petitioner has deducted from its gross income the payments made by it pursuant to the agreement with the Water Co. and the Fontana Co. (End of Findings.)

In its tax returns for 1935, 1936 and 1937, appellant deducted from gross income said amounts paid Water Company. The Commissioner disallowed said payments and solely as a result of such disallowance determined deficiencies in appellant's income taxes in the amounts of $2,536.66, $1,758.22 and $3,130.50, respectively, for those years; and deficiencies in excess profits tax in the amounts of $922.42, $189.87 and $2,787.58, respectively [T 1, 6]. In its decision the Board sustained the Commissioner and held the deficiencies to be as determined by the Commissioner [T 21].

Specification of Errors.

1. The Board erred in holding that the payments by appellant to Water Company for the years 1935, 1936 and 1937 in the amounts of $18,262.39, $16,244.55 and $27,000, respectively, were not deductible from appellant's gross income for the respective years paid.

2. The Board erred in holding said payments were distributions in the nature of dividends.

3. The Board erred in holding said payments were not deductible as interest.

4. The Board erred in holding said payments were not deductible as ordinary and necessary expenses of appellant's business.

I.

The Payments in Dispute Were Made to Water Company as Creditor and Not as Shareholder.

A. Provisions and Nature of Agreement Under Which Payments Were Made.

In the agreement, appellant was referred to as the party of the second part. The agreement [T 32, 33] recites and provides:

> "Whereas, it is not possible at this time to fix the definite value of the properties, easements and rights so to be acquired by the party of the second part from the parties of the first part, and to secure the approval of such value by the Railroad Commission of the State of California; and
>
> Whereas, it is necessary that construction be begun immediately upon the power plant and hydro-electric system proposed to be constructed by the party of the second part upon the real property forming part of the property so to be acquired by the party of the second part; and
>
> Whereas, the purchase by the party of the second part from the parties of the first part of the properties, easements and rights described in said two indentures hereunto annexed and the form of this agreement have been approved by the Railroad Commission of the State of California in its decision No. 3773, made and entered on the 10th day of October, 1916;
>
> Now, therefore, in consideration of the mutual covenants hereinafter expressed, the parties hereto do agree as follows:
>
> First: The parties of the first part agree forthwith to execute, acknowledge and deliver unto the

party of the second part two indentures substantially in the form of the drafts of indentures hereunto annexed and respectively marked Exhibit "A" and Exhibit "B" conveying and assigning to the party of the second part all the properties, easements and rights in such indentures described.

Second: The party of the second part, upon the execution and delivery to it by the parties of the first part of such indentures, and as part consideration for the properties, rights and easements thereby conveyed, agrees to issue to said Fontana Company a certificate of stock representing fifty (50) fully paid shares of the capital stock of said party of the second part, and to issue and deliver to said Fontana Union Water Company a certificate representing fifty (50) fully paid shares of the capital stock of the party of the second part.

Third: The party of the second part further agrees to pay to said Fontana Company and Fontana Union Water Company, one-half to each, the difference between the value of said one hundred (100) shares of the capital stock of the party of the second part and the value of the properties so to be conveyed by the parties of the first part to the party of the second part, as soon as the value of said properties and the method of payment therefore can be agreed upon between the parties of the first part and the party of the second part, and approved by the Railroad Commission of the State of California, or fixed in some other manner in accordance with law."

The agreement refers to the transaction as a *purchase*. It refers to the 100 shares to be issued *as part consideration,* and the covenant is to *pay* the difference between the value of the property and the 100 shares.

In the supplemental application [T. 25] the transaction is referred to as a *purchase* for a total consideration of $349,500 to be *paid*. There are numerous references to the *purchase price*, and the prayer is for leave to execute an agreement for the *payment of the remainder of the purchase price*.

Holding the agreement by its four corners, it shows an obligation on the part of appellant to pay the balance of the purchase price.

B. The Payments Were Not Net Profits as the Board Erroneously Assumed.

The agreement provided that "pending the fixing of the value of the properties so to be conveyed, and the payment of the remainder of the purchase price thereof," appellant should pay "all profits realized from the business of the party of the second part after paying all its operating expenses (including depreciation), taxes, interest, all obligations which it may incur or for which it may become responsible, and dividends of not exceeding eight per cent (8%) per annum, upon its outstanding capital stock" [T. 34].

The use of the expression "profits" in the agreement was unfortunate. The unthinking may assume it means net profits and requires the payment of that out of which dividends are paid or are payable, and hence, they conclude, the payment is a dividend. Nothing could be more wrong.

From "profits realized from the business" there is to be taken operating expenses, depreciation, taxes, interest, dividends and all obligations which appellant might incur or for which it might become responsible. If from gross

earnings or income there were taken operating expenses, including depreciation, taxes and interest, the remainder would be net profits or net income. But more is to come out and only that which remains, if any, is payable. The amount payable might be described as "unused profits."

The word "profits" was used in the agreement in stating a yardstick to determine the amount to be paid. The circumstances under which the agreement was made show it was intended as a temporary arrangement. Considering the relation of the parties and the circumstances, the agreement was not unusual. In building its power house, constructing a long steel pipe line, and embarking upon business, the extent of appellant's liabilities could not have been known, and it might well have been there would be nothing payable by appellant under the agreement. It would not have been surprising had the sellers waived interest or compensation for delay in payment of the purchase price. But they did not. They merely provided that if appellant's gross earnings exceeded operating expenses, dividends and amounts required for other purposes, the excess would be paid to the sellers.

The erroneous conception that the agreement required appellant to pay net income or surplus earnings (available in most corporations for dividends) permeates the findings and opinion of the Board, even reaching into the syllabus. The following excerpts from the findings and opinion will so show:

> "pending such determination to pay to them all of its *net profits*" [T. 6].
>
> "The amounts claimed by petitioner as deductions . . . were paid by petitioner to Water Co. pursuant to that provision of the agreement between the corporations calling for the payment of *all annual* net income" [T. 12].

"Since the commencement of petitioner's operations in 1917, all of its *net income* in excess of operating and other expenses and an 8 per cent dividend on its outstanding capital stock has been paid" [T. 12].

". . . provides for payment to the Grantors . . . of all petitioner's *net earnings*" [T. 14].

". . . the provisions for payment of petitioner's *earnings* to the Water Company is not found on the capital stock certificates" [T. 16].

"So long as the *annual net income* had to be paid to the Water Company the petitioner never could amass cash or free assets with which to repay the Water Co. at any time for the properties transferred" [T. 18].

"The mere fact that the aggregate *net income* paid over to the Water Company . . ." [T. 18].

"We must assume . . . that the company and the petitioner were satisfied with an arrangement whereby *all the profits* went to the Water Company under the agreement, and were not interested in creating any debtor-creditor relationship" [T. 19].

To what extent the erroneous conception of the Board respecting the measure of the payment may have influenced its opinion cannot be known, but it is apparent many of the quoted statements were based upon false premises.

That the payments were not the same as net income is established by the fact that, for the years involved, appellant's net taxable income (on which taxes were paid), apart from the payments to Water Company, amounted to $6,930.17, $1,919.93 and $15,114.98, re-

spectively [T. 4]. This was equivalent to an average net income, in excess of the disputed payments, of $7,985.03, or an earning of 76% on the par value of appellant's capital stock.

The unthinking may argue thus: This agreement required the payment of "profits." Dividends are paid out of profits. Therefore (they will conclude), the payments were a distribution of profits. The fallacy of such reasoning is to use the "Q. E. D." as a premise. All that is known is that the contract required a payment and laid down a yardstick for determining the amount. The nature of the payments must be determined before it can be known whether they were to be charged against gross earnings before net earnings or net profits might be ascertained.

C. The Rights and Relations of the Parties Are to Be Determined by the Provisions of the Agreement and Attending Circumstances.

Appellant made application to the Railroad Commission for leave to purchase from Fontana Company and Water Company (said last two corporations being hereinafter sometimes referred to as "sellers") a power house site, rights of way and the right to use waters of Lytle Creek for power purposes for the consideration of $349,500 [T. 25]. In this application appellant also sought a certificate of public convenience and leave to execute a mortgage and issue bonds [T. 7]. Unquestionably, action upon the application required extensive engineering studies, and the most involved and difficult of these would be determination of the value of the water power rights

of Lytle Creek, the flow of which would fluctuate seasonally and daily.

Appellant had acquired an option to purchase steel for the pressure pipe line to be constructed. This option expired October 6, 1916. Thereafter, the cost of steel would be "greatly increased" [T. 26].

After filing the application, it was found impossible to prepare and submit to the Railroad Commission at that time "data sufficient to enable the Railroad Commission to fix the value and approve the purchase price of said property" [T. 26]. To meet the urgency, appellant and sellers decided to convey the properties and fix the purchase price later, and leave of the Commission was sought to enter into the agreement subsequently executed. The alleged reason for making the agreement was "in order to prevent the loss of such valuable steel contract, and to provide further time within which data may be furnished to and considered by the Railroad Commission for the fixing of the value and approval of the purchase price of the properties so to be conveyed by Fontana Union Water Company and Fontana Company to Fontana Power Company" [T. 26].

The reason for making the agreement and the language of the agreement are so clear and certain that its legal effect and meaning are to be resolved from its language and the surrounding circumstances. The case should not be confused with cases determined by other principles, such as those involving attempts to distribute profits under the guise of debt payments, or to evade taxes.

At the time the agreement was made, the Revenue Act of 1913 was in effect and imposed a 1% tax on the net income of individuals and corporations. It was not until

the United States entered the World War and the Revenue Act of 1918 was enacted that taxes became sufficiently burdensome to receive consideration from business.

D. The Payments Were Not Attributable to Any Rights of Water Company as Holder of Issued Shares.

The Board appears to have decided the case on the theory that the relation of Water Company to appellant was that of shareholder and not creditor. Hence, the payments were in the nature of dividends. The Board says "In a majority of the cases of this nature which have come before this Board, the instrument issued by the corporation has been some form of stock certificate" [T. 15]. Nowhere in the extensive briefs filed with the Board was there any express discussion of such theory.

The ultimate question for determination is the nature of the payments. Were they paid as dividends or in discharge of a debt? If the payments were attributable to a creditor relation, they were interest or an expense of business. If attributable to the shareholder relation, they were dividends.

It should be noted there are two classes of cases. The facts are easily distinguished but principles are sometimes confused. In one, the recipient is admittedly a shareholder. The fact of shareholding is not involved. But the payment is made under the guise of discharge of indebtedness as for salary or rent. The payee is an admitted shareholder, but also claims to be a creditor. The matter for determination is how much of the payment, if any, was attributable to the creditor relation, and how

much, if any, was attributable to the shareholder relation? Such cases may involve questions of tax evasion.

In the other class of cases the question is whether the payee is a creditor or shareholder. The most common of these involve debenture shares. The holder of debenture shares may also hold other shares, such as common. But such other shareholding is merely incidental. The payment is not attributable to such other shares.

In the instant case, Water Company was a shareholder. But that was incidental. The payments were not attributable to the holding by Water Company of 100 shares of common stock. The payments were attributable to rights distinct from the rights of Water Company as the holder of 100 shares. They were made because of an obligation imposed on appellant by the agreement. It is immaterial who owns this agreement, that is, who may be entitled to the payments under it, whether a shareholder or a non-shareholder, just as it is immaterial who holds the debenture shares. The terms of the debenture shares will determine whether there exists the debtor-creditor relation or that of shareholder.

If Water Company should sell a half interest in the agreement to one holding none of appellant's shares, retaining the other half interest and the 100 shares, it could not be that the payments to Water Company were dividends while those to the non-stockholder were something else.

The payment of moneys by a corporation to shareholders who take by reason of a contractual obligation, rather than by virtue of being stockholders, does not constitute a distribution in the nature of a dividend, notwithstanding the fact that the moneys so paid would have

constituted surplus profits but for the contractual obligation. *Uniform Printing and Supply Company v. Commissioner* (1937-C. C. A. 7), 88 F. (2d) 75, 109 A. L. R. 966.

E. Appellant Could Not Issue Stock or Long Term Evidences of Indebtedness Without Approval of Railroad Commission.

At the time of its incorporation, and subsequently, appellant was subject to the Public Utilities Act of California adopted in 1915. *(Cal. Stats. 1915, p. 115.)*

Section 52(a) of that Act provided:

> "The power of public utilities to issue stocks and stock certificates, and bonds, notes and other evidences of indebtedness and to create liens on their property situated within this state is a special privilege, the right of supervision, regulation, restriction and control of which is and shall continue to be vested in the State, and such power shall be exercised as provided by law and under such rules and regulations as the commission may prescribe."

And in section 42(b) of said Act was the provision:

> "A public utility may issue stocks and stock certificates, and bonds, notes and other evidences of indebtedness payable at periods of more than twelve months after the date thereof, for the following purposes and no others, namely, for the acquisition of property, or for the construction, completion, extention or improvement of its facilities, . . ."

Emphasizing the limitation upon the power to incur indebtedness was the provision in said section 52(b):

> "A public utility may issue notes, for proper purposes and not in violation of any provision of this act, or any other act, payable at periods of not more than twelve months after the date of issuance of the same, without the consent of the commission."

It may be assumed that appellant might have acquired the property for cash or notes payable in not more than twelve months, but to acquire it for stock or evidences of indebtedness not payable within twelve months definitely required the approval of the Commission.

F. Appellant Could Not Have Created a Stock Interest With Rights Like Those Created by the Agreement.

The rights of Water Company were created by and are held pursuant to the agreement. Such rights are those of either creditor or stockholder. If the agreement establishes a stock interest or if the rights of appellant under the agreement are those of stockholder, appellant must have two classes of stock, one herein called orthodox stock provided for in the Articles of Incorporation, and the other called unorthodox stock created by the agreement.

Among other things, these classes have different dividend rights, the orthodox stock having priority over the unorthodox stock to the extent of 8% dividends. The orthodox stock has voting power while the unorthodox stock has no voting power. Tht orthodox stock is divided into shares of the par value of $100. The unorthodox is not divided into shares, or perhaps consists of one share, and it has no par value.

Under the California constitution in effect at the time the agreement was made, a California corporation could not have par and non-par shares, nor shares of different par values, nor shares with different voting rights.

California Constitution Art. XII, Secs. 3 and 12;

Del Monte L. & P. Co. v. Jordan, 196 Cal. 488, 238 Pac. 710;

Land Development Company v. Jordan, 198 Cal. 346, 245 Pac. 187;

6a *Cal. Jur.*, p. 362.

At that time the constitution had very restrictive and exacting provisions relating to corporations. Among other things, it was provided that each stockholder should be personally liable for that part of the corporation's debts that the amount of stock owned by him bore to the whole of the subscribed capital stock.

If the agreement in question made Water Company a stockholder, what would have been its liability to the creditors of appellant? Any suit upon the agreement to establish a liability of Water Company as stockholder would have been demurred out of Court so quickly that wonder would never cease it had been brought. Even today, when shares are classified, there must be a statement of the classes, preferences, privileges and restrictions in the Articles (Cal. Civil Code, Sec. 290), and certificates for shares must be issued, which must contain a similar or equivalent statement (Cal. Civil Code, Sec. 326).

Assuming the agreement was susceptible to two constructions, one creating the debtor-creditor relation, and the other a stockholder relation, and the former was legal

and valid and the latter was contrary to law or public policy, the former construction will be adopted (13 C. J. 539).

As hereinbefore shown, appellant might only issue stock and long-term indebtedness for certain purposes and with the approval of the Railroad Commission. The Commission authorized the agreement under which the payments were made. Did the Commission intend by this agreement to authorize the issuance of stock or the creation of a debt or liability. Any claim that the Commission intended to authorize the issuance of shares is unfounded.

If the parties to the agreement had intended that the interest under the agreement should be a stock interest, and had they employed the most appropriate words known to them to express such intent and had the Railroad Commission expressly approved the agreement with such expressed intent and authorized the creation of a stock interest, it would have been ineffectual, for it was not within the power of the parties nor of the Railroad Commission to create a stock right or interest in appellant of the nature of that shown by the agreement. The California Constitution prohibited it.

And still, the Board has necessarily held that a thing may be done indirectly that could not be done directly; that a result will be obtained unwittingly that could not be obtained wittingly, and that one may be a stockholder unintentionally when he could not be one intentionally.

G. An Obligation to Pay, Enforceable by the Obligee, Establishes the Relation of Debtor-Creditor.

In the instant case, Water Company had an unconditional right to the amounts appellant agreed to pay pending payment of the balance of the purchase price, and Water Company could have enforced such right by suit or other appropriate action and without regard to general or other creditors. Water Company also had an unconditional right to the balance of the purchase price and such right could have been enforced by appropriate action which might have involved the Railroad Commission had it been in existence and refused to act. In any event, performance or non-performance was not controlled by appellant, and appellant could not postpone time of performance any more than could a debtor, by dilatory tactics, postpone time of payment of his debt.

As no time was provided in the agreement for payment of the balance of the purchase price, it was payable on demand or in any event within a reasonable time.

Where a corporation is definitely obliged to pay "dividends" on and to redeem its "preferred" stock, the "dividend" payments constitute interest under the Revenue Act.

Commissioner v. Proctor Shop, Inc. (1936- C. C. A. 9), 82 F. (2d) 792;

Commissioner v. Palmer, Stacy-Merrill, Inc. (1940- C. C. A. 9), 111 F. (2d) 809;

Arthur R. Jones Syndicate v. Commissioner (1927- C. C. A. 7), 23 F. (2d) 833.

In the *Proctor Shop* case, *supra,* the capital stock authorized by the articles was 10 shares of common of the par value of $100 each and 990 shares of debenture preferred stock of the par value of $100 each. All of the debenture stock was taken and held by the father of the president. The articles provided for 6% cumulative interest on the debenture stock, payable quarterly, before any dividends were paid on the common and required the corporation to redeem at least $1,500 per month of the debenture stock. Failure to pay the "interest" for two years as the same became due, authorized the holders of the delinquent stock to declare the principal due and institute action against the corporation for the principal amount and accrued interest. All general creditors ranked ahead of the holders of the debenture shares. In its annual report to the state corporation department, the corporation reported the debenture stock as a part of its authorized capital.

There was no question there (as there is here) of the power of the corporation to issue stock with such characteristics and there was no question of the validity of the debenture shares either as stock or indebtedness. Notwithstanding the provisions of the articles and the clear intent of the corporation to issue stock and establish a stockholder relation, the payments were held to be interest. That decision turns upon the fact that the corporation was obligated to redeem the shares, and possibly the right to sue in event of failure to pay interest for two years. These two facts overcame the manifest intent to make the holder have a stock interest.

Nearly all of the reasons advanced by the Board in the instant case for holding appellant to have a stock interest

could have been more appropriately advanced in the *Proctor Shop* case.

It is a fact that both creditors and shareholders of a corporation have an "interest" in it, and each has an investment. But a proper decision can never be reached by considering whether one is "interested" in the other or has the interest of an investor.

In the *Proctor* case the common stock interest was 1% and the debenture interest held by one person was 99%. In the instant case (attributing a total of $350,000 to the properties), the stock interest represented by 105 shares is 3% and the other interest represented by the agreement is 97%. Why, in the *Proctor* case, did this Court not say, in effect, that debenture shares represented the real interest in the corporation and, hence, "the relationship . . . was that of an investor and not that of a creditor," as the Board said in the present case? That was not said in the *Proctor* case because the question cannot be answered through such approach.

In the *Arthur R. Jones Syndicate* case, one party took at par all of an issue of $250,000 14% debenture shares. These were payable at a definite time. Therefore, although called shares, and authorized by the articles, and valid under the law, the payments were held to be interest.

In the numerous cases involving debenture shares, the legal power and right of the corporations to issue the shares with the terms and provisions there applicable were not involved. Apparently in all instances the debenture shares under consideration had been issued pursuant to and in compliance with law and the Articles of Incorporation and after formal and deliberate corporate action.

But in the instance case, as shown elsewhere, it was not within the power of appellant to create such stockholder relation—not even with the approval of the Railroad Commission—for such was prohibited by the constitution and also by the Civil Code of California.

H. The Reasons Advanced by the Board Are Not Well Founded.

In the opinion of the Board, it was written "Had the Water Co. wanted to treat the transaction merely as a loan, with a definite annual income, in the nature of interest, from the transaction, it could have demanded a certain fixed payment from the petitioner each year until a certain fixed date, when the principal should become unconditionally due" [T. 16].

The statement ignores the reasons that induced the agreement and that appellant might not incur an obligation payable after 12 months without authorization by the Commission. The parties started out to make definite terms, but the time element upset their plans. They, therefore, made an agreement that was intended as a substitute until the definite terms could be settled. They postponed finishing that which they had started.

Had the parties made a permanent and final arrangement providing for paying unused profits, there might have been better grounds for inferring the interest of Water Company thereunder was intended to be a stock interest. But the agreement shows the purchase price *to be paid* remains for determination. If the agreement made shareholders of Water Company and Fontana Company, why bother thereafter to fix the purchase price?

An agreement of the nature suggested by the Board would not have been appropriate. Why should they have provided for periodic payments over the years "until a certain fixed date when the principal should become unconditionally due"? Had the purchase price been known or determined at that time, it is quite probable they would have provided for periodic payments "until a certain fixed date when the principal should become unconditionally due." The parties were not free agents as the Board implies. Such an agreement could not have been made without approval of the Commission, and it is improbable the Commission would have approved an obligation providing for definite payments until the purchase price was established.

The Board seems to think that a promise to pay a definite amount indicates a creditor relation because that is usually done. Debtors and creditors generally do know the amount of debt and agree upon an interest rate. But there are many exceptions, among them being the debenture share cases where the amount invested and the dividend or interest rate is certain. Nor does it apply where the amount of debt is not known.

Suppose an individual had purchased these properties and had made the same agreement that appellant did. The stockholder relation could not exist in such case. Would the agreement have created a stockholder relation if the purchaser were a corporation, but a debtor-creditor relation if the purchaser were an individual?

In the Board's opinion, it is written [T. 17]:

> "No amount equivalent to the value of the properties transferred could have been paid in cash by petitioner at that time, inasmuch as it had neither cash nor unpledged assets; nor could it ever be paid

> in the future if the Water Company held petitioner to the terms of the agreement because so long as the annual net income had to be paid over to Water Co. the petitioner never could amass cash or free assets with which to repay the Water Co. at any time for the properties transferred."

The foregoing is a naive argument. It appears to assume that corporations come into this forld with an inheritance. It ignores the fact that corporations do sell their shares for cash, or acquire property for them. It overlooks the fact that appellant had pending before the Railroad Commission an application to acquire the properties for $349,500, when, because of time consideration, the application was side-tracked. It improperly concludes that appellant could not have secured the $349,500, or such amount as the Commission might have approved as the purchase price, with which to acquire the property. It erroneously assumes that all of appellant's net income was payable under the agreement, in lieu of as much of it as appellant did not require for dividends and other obligations. It disregards the fact that at the time the opinion was rendered appellant must have paid off the greater part of its bond issue, unless it had defaulted under the trust indenture. In brief, the quoted statement is 100% wrong.

Also, in the opinion of the Board is the statement [T. 19]:

> "From the facts it appears that in all the years from 1917 until the present time there was no attempt made to agree on a valuation of the properties. . . . We must assume . . . Water Co. . . . and the petitioner . . . were not interested in creating any debtor-creditor relationship."

In the foregoing, there is an inference that the parties could have changed their relationship. If the original agreement created a stockholder relationship, then to convert that to a debtor-creditor relationship would have necessitated the purchase by appellant of an outstanding stock interest or the redemption of stock. Under the law, appellant could not have done that.

It is probable the Board means to say that the subsequent actions of the parties indicate they intended in the first instance to create a stockholder relation. Ordinarily, acts of parties to an agreement by way of performance may be helpful in determining the meaning of the agreement. But any conclusion that the subsequent failure to fix the purchase price shows the parties intended never to fix it or shows that they intended the agreement should be permanent and the measure of their rights, is unjustified. It ignores the reasons for making the agreement and the clear language of the agreement itself.

Before this agreement was finally approved by the Commission [T. 38] the United States was in the World War and there were other things more important for engineers than valuation studies of water power, and the market for stock that existed in the early fall of 1916 was non-existent. If thereafter the parties found the arrangement workable and maintained the status quo. that would not convert a debtor-creditor relation that arose when the contract was executed into a shareholder relation.

Even had the agreement provided that payment of the purchase price when determined was to be made with appellant's stock at par, such would not have made the compensation payments dividends. *Fidelity Savings and Loan Association v. Commissioner,* 23 B. T. A. 1059.

II.

The Payments Involved Constituted Interest.

Section 23(b) of the Revenue Act of 1934 and the same section of the 1936 Act provided:

> "In computing net income there shall be allowed as deductions . . . (b) Interest. All interest paid or accrued within the taxable year on indebtedness."

Interest is compensation for the use, forbearance or detention of money. 33 C. J. 178; *Fall River Electric Light Company v. Commissioner,* 23 B. T. A. 168. It is usually reckoned by a percentage. 4 Words & Phrases, p. 3708 citing Abbott's Law Dictionary and 11 Am. & Eng. Enc. Law 379. The fact that it is usually reckoned by a percentage negatives any claim that it is always so reckoned. Numerous cases where not reckoned by a percentage are where usury has been paid in property. 66 C. J. 212. But a contract is not usurious where the amount of interest is affected by a contingency putting the whole of it at hazard, even tho the probable amount is greater than lawful interest. 66 C. J. 136. Sometimes it is reckoned as a percentage of profits, as it was in the recent case of *Kena, Inc. v. Commissioner,* 44 B. T. A., No. 39.

In the *Kena* case the question was whether or not moneys received by a taxpayer corporation were interest. If they were, the taxpayer was a personal holding company. The stock was held by one de Mauriac and his wife. A large sum of money was "loaned" to de Mauriac for

stock trading, which he agreed to repay, together with "an additional sum of money *in lieu of interest*, which additional sum shall be an amount equal to 80 per cent of the net profits of de Mauriac in his stock trading business." The 80% was subsequently reduced to 66⅔%, and taxpayer received $124,000 as 66⅔% of the profits for the tax year involved. In passing on this situation the Board said:

> "The contract of December 13, 1932, denominated the amount to be paid to the petitioner as an additional sum in lieu of interest. The word 'lieu' means 'place or stead.' It does not imply that the character of the payment was different from interest but indicates that the method of computation was not in accord with the usual method of computing interest, the percentage of profit being employed as a substitute. . . .
>
> The record convinces us that the amount originally delivered to de Mauriac and the amount subsequently advanced under the extended agreement were loans of cash made by the petitioner to de Mauriac. The amounts paid for the use of such borrowed money were interest thereon.
>
> It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower."

It is not necessary that a payment be denominated or paid as interest to be deductible as interest. In many of the debenture share cases the payment held to be interest was termed a dividend. The portion of an annuity payment representing interest may be deducted by an annuity writer. *Commissioner v. John C. Moore Corp.,* 42 F. (2d) 186. A bonus for a loan, although payable in the form of dividends, has been held interest. *Wiggin Terminals, Inc. v. U. S.,* 36 F. (2d) 893.

Under treasury regulations, payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but if irredeemable are deductible as rent to the extent they constitute a proper business expense. Reg. 103, sec. 19.23 (b)-1. A payment may be in part interest and in part a dividend. *Helvering v. Richmond, F. & P. R. Co.,* 90 F. (2d) 971, where payments to the extent of 7% of the par value of the guaranteed stock were held to be interest, and the excess to be dividends.

III.

The Payments Were Deductible as Ordinary and Necessary Expenses of Business.

Section 23(a) of the Revenue Act of 1934 and the same section of the Act of 1936 stated:

> "In computing net income there shall be allowed as deductions: (a) Expenses. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

In determining what is ordinary and necessary expense in a given business, the facts peculiar to that business as it has been constituted and is conducted must be considered, and an expense might be ordinary and necessary in one instance where in another it was not, and this is true whether the businesses are similar or different. The statute singles out the taxpayer and allows him a deduction for ordinary and necessary expense in his business as it is constituted and conducted.

As noted, the treasury holds that payments under an irredeemable ground rent are deductible "to the extent they constitute a proper business expense." Such deductions are not allowed under the provisions of section 23(a) authorizing deductions of rentals, for in the case of the ground rent, as in the instant case, fee title has been conveyed, and the relation of the parties is not that of landlord and tenant and that which is paid is not orthodox rent.

Where one transferred all interest in certain coal leases to another under an agreement that the assignor should be paid certain amounts on the coal produced, it was held such payments, although neither rent nor royalties, were

a charge upon the business and were deductible as ordinary and necessary expense of the business. *Buffalo Eagle Mines, Inc. v. Commissioner,* 37 B. T. A. 843. Where a consolidated corporation agreed to pay two shareholders of a constituent corporation 12½% of the net profits before any dividends were declared, the payments were held ordinary and necessary expense of the business. *George La Monte & Son v. Commissioner,* 32 F. (2d) 220. In the case last mentioned the Court said respecting the fact that the payment was determined by profits, "it is not the method of determining the amount of the charge which is controlling, or even of importance; it is the character and nature of the charge."

Where a film company contracted with ten manufacturers, each owning 10% of its stock, to lease their films at nine cents a foot, plus a payment at the end of the year in proportion to the footage leased, equal to its profits after paying dividends on its common and preferred shares at specified rates, the additional payments, although taking all net profits above dividends, were held to be an expense of the business and not a distribution of dividends. *In re General Film Corporation,* 274 F. 903.

Where a very substantial salary was paid to the seller of a business to direct or assist the purchasers in conducting the business, the salary payments were ordinary and necessary expenses of the business. *Nehi Bottling Company,* B. T. A. memo, Docket No. 102054, May 27, 1941. And where a corporation leased from its president and majority shareholder a lumber yard, office and other buildings at an annual rental of half of the corporation's income from such sources, the amount so paid was deductible as rent. *Canfield Lumber Company v. Commissioner,* B. T. A. Memo, June 7, 1940.

The agreement in question was made in connection with acquiring the property required and used by appellant in its business. Without such property, appellant could not have started its business, nor without it, could it continue. The payments in the instant case are as ordinary and necessary as are the royalty payments under the lease of a coal mine, or as interest on a purchase money obligation or as rent for property used in a business, for in the instant case the obligation to make the payments arose in connection with the acquisition of the property, namely, the power house site, the right of way for the pipe line, and the right to use the water for power purposes.

Conclusion.

For the reasons hereinbefore given, the decision of the Board is erroneous and should be reversed.

Respectfully submitted,

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